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No. 94-1895

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1994

ERROL PAYNE, RICHARD PENFIL, MEDSTONE INTERNATIONAL, INC. and WEEDEN & CO., L.P.,

Petitioners,

vs.

WILLIAM KAPLAN, THOMAS DEVERE, and GEORGIANE KRAMER,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED BY PETITIONERS

1. In a class action under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, what standard should apply to determine when stock sales by corporate executives, standing alone, constitute circumstantial evidence sufficient to raise a triable issue on the question of scienter?

2. Under Section 11 of the Securities Act, are companies under an affirmative duty to disclose data regarding clinical trials, "however preliminary," prior to the completion of those trials?

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I. SUMMARY OF ARGUMENT

This case presents no questions warranting this Court's consideration. The Ninth Circuit's opinion raises no conflict of law among the circuits, nor any questions of importance on which the law is unclear or unsettled. At most, this case involves the application of settled principles to a specific set of facts, and a holding that on those facts certain defendants' state of mind presents a jury

question. Defendants may disagree with this determination, but that is no ground for certiorari.

The case does not even present the legal issues that petitioners state as the "Questions Presented."

In the first purported "Question Presented," petitioners ask this Court to determine "what standard should apply to determine when stock sales by corporate executives, *standing alone*, constitute circumstantial evidence sufficient to raise a triable issue on the question of scienter." (Emphasis added.) This case presents no such question. Defendants' insider stock sales did not "stand alone" in this case, as other evidence tended to demonstrate that defendants' public statements were undermined by facts known only to them.

The Ninth Circuit concluded that on the facts of this case a jury question exists on the issue of scienter. In reaching this determination it applied settled law and did not adopt or apply any new rule or "standard," as defendants suggest.

If, however, the question of when stock sales "standing alone" might raise an inference of scienter *were* presented by this case, it would be a waste of this Court's precious time to answer it. Insiders' stock sales seldom, if ever, "stand alone" as the only circumstantial evidence of scienter in *any* securities fraud case. As in this case, they usually are just one part of a complex web of evidence that may or may not, in aggregate, be sufficient to support a jury inference of scienter. Thus, even if a new "standard" could be framed regarding inferences of scienter from stock sales "standing alone," it would have little relevance either to this case, or to others.

Defendants' second purported "Question Presented" asks this Court to determine whether § 11 of the Securities Act imposes "an affirmative duty to disclose data regarding clinical trials, 'however preliminary,' prior to the completion of those trials." Once again, no such question is presented on the record of this case.

Although defendants suggest this case involves some generalized duty to disclose preliminary medical test results, nothing could be further from the truth. This is a case where defendants made affirmative representations *on the basis of* preliminary test results, when those results *actually contradicted* defendants' public statements. The Ninth Circuit held that "[h]aving used the study results to justify its prospectus statements, Medstone may not simultaneously claim that the study was too preliminary to disclose." (A16). This is a far cry from defendants' representations to this Court, that the Ninth Circuit created a generalized duty to disclose clinical test results.

Moreover, if this case actually did present any question of sufficient importance to warrant this Court's attention, it is better left for disposition at a later stage in the case – after a fuller record has been developed. The Ninth Circuit merely held that summary judgment should be denied, so that litigation of the case might proceed. Issues such as materiality and scienter are highly fact-sensitive, and can better be decided on a fuller record if they need to be decided by this Court at all.

II. ARGUMENT

A. This Case Does Not Present The Question Of When Stock Sales "Standing Alone" May Raise An Inference Of Scienter

This case does not present a question that is worthy of certiorari about when stock sales may raise an inference of scienter.

1. This Case Does Not Present The Question Of Whether, Or According To What "Standard," Stock Sales "Standing Alone" May Raise An Inference Of Scienter

The Ninth Circuit did not hold that evidence of insider trading "standing alone" raised an inference of scienter.

Although plaintiffs' evidence included evidence of massive insider trading by two individual defendants, this evidence did not "stand alone" as the only evidence relevant to defendants' scienter. This case involves *documented misrepresentations*, made when data available to the defendants tended to demonstrate the falsity of their statements. (A10-A12). Specifically, defendants told the public, in a prospectus designed to induce the purchase of Medstone stock, both that the Company's medical device for treating kidney stones and gallstones "compared favorably" with competitors' products "with respect to its imaging system . . . and its success rate in treating patients," (A10), and that the product "has been used successfully to treat kidney stone patients since October 1986 and gallstone patients since January 1988." (A11). Data known to the defendants – including clinical

trials on which the statements supposedly were based – indicated precisely the contrary. (A10-A11). Defendants knew that the Medstone product's "success" rate in treating patients was extraordinarily low – just 18.5%, as compared to 80% for the leading competitor with which it supposedly "compared favorably." (A10-A11).

Plaintiffs presented *additional* affirmative evidence tending to demonstrate scienter and controverting defendants' "good faith": evidence of two individual defendants' insider stock sales in suspicious amounts and at suspicious times. (A25-A26).

> [Defendant] Payne, Medstone's CEO at the time of the public offering, sold two-thirds of his stock in the fall of 1988 for $6.5 million, and Penfil, Medstone's president, sold one-fourth of his stock at the same time for $2.4-2.5 million. These sales occurred as soon as was legally possible after the public offering in June 1988. Penfil then sold the rest of his stock for another $4.5 million in August of 1989, just before the publication of Medstone's [unfavorable] clinical results.

(A25).

This evidence did not "stand alone"; it was a part of the entire matrix of evidence presented in the case. In light of the entirety of the evidence offered in opposing summary judgment – demonstrating both the unfavorable performance of the Medstone product known to the defendants, and the falsity of defendants' statements about it in a prospectus designed to induce the purchase of Medstone stock (A10-A12) – plaintiffs argued that "these sales coincided with the anticipation that negative

information about Medstone would surface." (A25). The Ninth Circuit agreed that "Payne and Penfil's stock sales, *in conjunction with the allegations that they were aware of undisclosed negative information about Medstone, do raise suspicions about their intent,* as they are massive sales alleged to have been calculated to avoid the negative effects of undisclosed inside information." *Id.* (emphasis added).[1]

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[1] Defendants incorrectly assert the circuit court held that liquidation of executive's stock holdings upon departure from a company always is a "suspicious amount" of trading under *In re Apple Computers Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990). Pet. at 8. The Ninth Circuit said no such thing. (A25). Nor could such a holding even be implied from the facts of this case. Defendant Penfil, for example, sold 25% of his Medstone stock for $2.5 million in September 1988, long before he resigned in August 1989. (A25). The court properly rejected defendants' "innocent" explanation – that they sold the stock to reap financial benefits for personal reasons – as begging the question "whether they acted on the basis of undisclosed inside information in order to reap large returns." (A26).

Defendants' contention that the Ninth Circuit reversed summary judgment for petitioner Weeden & Co. solely because Mr. Hill of Weeden sat on the Medstone's Board is similarly not true. As set forth at pages A27-A28 of the appendix to the petition, the Ninth Circuit (i) found that Hill's declaration does not establish as a matter of law that Weeden lacked scienter, and (ii) observed that the district court cast some doubt on the reasonableness of Weeden's due diligence investigation and noted the possible conflict of interest Weeden faced. (A27-A28). The Ninth Circuit concluded that given these unresolved issues about Weeden's objectivity and Hill's membership on the board, even without evidence of any insider trading, the affidavit from a single Weeden officer did not establish Weeden's lack of scienter as a matter of law. Clearly insider trading was *not* the "sole admissible evidence" of scienter, as defendants falsely assert.

Ultimately, the Court concluded that the evidence presented a question of fact as to the defendants' scienter, in light of all of the facts and evidence presented in this case. Thus, the first "Question Presented" is, in fact, not presented at all on the record in this case.

2. This Case Presents No New Legal "Standard" Regarding Inferences Of Scienter From Insider Stock Sales, And Presents No Conflicts Among the Circuits

Defendants suggest that the decision below produced a conflict between the Ninth and the Second Circuits on the "standard" of when insider trading "standing alone" raises an inference of scienter. In fact, Ninth Circuit law on inferences from insider stock sales is identical to the Second Circuit law. The Ninth Circuit *follows Second Circuit law*, and the "standard" it applies *comes from* the Second Circuit precedents.

There is no conflict among the circuits. Defendants acknowledge that in *Goldman v. Belden*, 754 F.2d 1059, 1070 (2d Cir. 1985), the Second Circuit held that stock sales "in suspicious amounts or at suspicious times" are probative of bad faith or scienter. Pet. at 13. The Ninth Circuit adopted this standard with *Apple*, 886 F.2d at 1117. Indeed, in *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995), the Second Circuit relied on the Ninth Circuit's holding in *Apple* to hold that the *Goldman* standard was not met. Substantially the same standard is articulated and applied by circuit courts and district courts across

the country.[2] The Ninth Circuit, by applying this standard in the opinion below, (A25-A26), established no new legal standard and produced no conflict among the circuits.

Of course, because scienter is a fact-sensitive inquiry,[3] plaintiffs win some cases, and defendants win in others. That does not create a conflict among the circuits. Quite to the contrary, this simply reflects the results of applying a uniform standard to the facts of specific cases.

Defendants argue that in *Acito* the Second Circuit held that "a trade involving a substantial block of stock alone is not enough to give rise to an inference of scienter." Pet. at 15. But they indicate that the law is the same in the Ninth Circuit under *Apple*. Pet. at 14; *see Apple*, 886 F.2d at 14. The decision below, like *Acito*, applies the legal standard of *Goldman* and *Apple*. (A25-A26). Although it reaches a different result than *Acito* on the particular facts presented in this case, that does not mean there is a conflict between the Ninth Circuit and the Second Circuit. There is, of course, a stark distinction between this case and

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[2] *See, e.g., In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1427 (9th Cir. 1994); *Rubinstein v. Collins*, 20 F.3d 160, 169 & n.3 (5th Cir. 1994); *Greenstone v. Cambex Corp.*, 975 F.2d 22, 26 (1st Cir. 1992); *In re Cryomedical Sciences, Inc. Sec. Litig.*, Civ. No. AW 94-873, 1995 U.S. Dist. LEXIS 5970, at *59 (D. Md. April 26, 1995); *Searls v. Glasser*, No. 91 C 6796, 1994 U.S. Dist. LEXIS 13509, at *30 (N.D. Ill. Sept. 21, 1994); *SEC v. Shared Medical Systems Corp.*, Civ. No. 91-6546, 1994 U.S. Dist. LEXIS 11952, at *3 (E.D. Pa. Aug. 25, 1994); *In re the Leslie Fay Cos.*, 835 F. Supp. 167, 172 (S.D.N.Y. 1993); *In re Lifecore Biomedical, Inc. Sec. Litig.*, 159 F.R.D. 513, 517 (D. Minn. 1993).

[3] *See Hanon v. Dataproducts Corp.*, 976 F.2d 497, 500 (9th Cir. 1992); *Levinson v. Basic Inc.*, 786 F.2d 741, 749 (6th Cir. 1986), *vacated on other grounds*, 485 U.S. 224 (1988).

Acito: in *Acito* the plaintiffs could not even plead that defendants had made materially false or misleading statements. *See Acito*, 47 F.3d at 52-53. Further, *Acito* is a pleading decision, not a summary judgment decision. The "conflict" defendants strive to manufacture simply does not exist.

The Ninth Circuit's decision in this case is a fact-specific determination based on settled legal principles that the evidence of defendants' scienter was sufficient to go to a jury. The results of applying a uniform standard necessarily vary depending on the facts of each case. While defendants disagree with the results in this case, that is not an adequate ground for demanding review by this Court.

3. A Ruling By This Court As To When Insider Stock Sales "Standing Alone" May Raise An Inference Of Scienter Would Be Of Little Or No Utility

It is doubtful that insider trading will ever "stand alone" as the only evidence relevant to scienter in a securities-fraud case. This Court has recognized that proof of scienter in securities fraud cases "is often a matter of inference from circumstantial evidence," *Herman & MacLean v. Huddleston*, 459 U.S. 375, 391 n.30 (1983), as it warned against adopting high standards of proof for scienter.[4] " 'Sometimes very slight circumstances, apparently trivial in themselves, when joined

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[4] *Id.* ("If anything, the difficulty of proving the defendant's state of mind supports a lower standard of proof.").

with other facts, may afford strong proof of fraud.' "[5] In *Bourjaily v. United States*, 483 U.S. 171, 179-80 (1987), this Court recognized that "individual pieces of evidence, insufficient in themselves to prove a point, may in cumulation prove it." That being so, it is difficult to see any utility in a decision by this Court on the "standard" for when evidence of insider stock sales "standing alone" may raise an inference of scienter.

Every case is different. In the Ninth Circuit, some decisions draw an inference of scienter on the basis of false statements that are seriously undermined by facts known to the defendants – without considering insider stock sales. In *Hanon*, 976 F.2d at 507, the Ninth Circuit found that evidence of technical flaws in an inkjet printer was evidence of scienter sufficient to overcome a motion for summary judgment as to optimistic statements regarding the printer. In *Apple*, the Ninth Circuit held that "significant technological flaws" in a disk drive were sufficient to raise "a genuine issue of material fact" as to the recklessness of statements regarding that product. *Apple*, 886 F.2d at 1115. The same opinion held that evidence, including insiders' stock sales, was insufficient to raise an inference of scienter regarding other statements about a computer. *See id.* at 1117-18.

In this case, with misleading statements and certain defendants' insider trading pitted against defendants' declarations of good faith, the court found a jury question

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[5] *Tcherepnin v. Franz*, 485 F.2d 1251, 1259 (7th Cir. 1973), *cert. denied*, 415 U.S. 918 (1974) (citation omitted); *accord, e.g., Wilson v. S&L Acquisition Co., L.P.*, 940 F.2d 1429, 1440 (11th Cir. 1991).

about the scienter of those individual defendants. Evidence of insider trading hardly "stood alone." *See supra.* Thus a determination of when stock sales "standing alone" may raise an inference of scienter would have little relevance to this or future cases.

4. The Ninth Circuit's Decision Does Not "Eviscerate" The Distinction Between § 11 Of The Securities Act And § 10(b) Of The Securities Exchange Act

Defendants say the Ninth Circuit "eviscerates" the distinction between liability under § 11 and liability under § 10(b). It does nothing of the sort.

Defendants suggest that leaving the matter of scienter to the jury somehow conflicts with this Court's observation in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209 (1976), that § 10(b) of the Securities Exchange Act of 1934 and § 11 of the Securities Act of 1933 have different elements and are subject to somewhat different "procedural restrictions," relating to security for costs, attorneys' fees and the like. Defendants ignore the fact that plaintiffs in this case pleaded a violation of § 11,[6] so that it simply cannot be contended in this case that plaintiffs tried to sidestep the "procedural protections" of § 11.

In *Hochfelder*, this Court held only that "these procedural limitations indicate that *the judicially created private damages remedy under § 10(b)* – which has no comparable restrictions – *cannot be extended . . . to actions*

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[6] Much of the Ninth Circuit's opinion deals with § 11 claims. (A9-A17).

premised on negligent wrongdoing." Hochfelder, 425 U.S. at 210 (footnote omitted and emphasis added). Thus, scienter is an element of a § 10(b) claim, but not of a § 11 claim. The Ninth Circuit did not hold otherwise.

Perhaps what defendants object to is the fact that, when defendants act with scienter, the same fraudulent conduct may violate both § 11 and § 10(b). There is nothing wrong with this. In *Huddleston*, 459 U.S. at 383 (1983), this Court held that "[w]hile some conduct actionable under § 11 may also be actionable under § 10(b), it is hardly a novel proposition that the 1934 Act and the 1933 Act 'prohibit some of the same conduct,' " and that " '[t]he fact there may well be some overlap is neither unusual nor unfortunate.' " *Id.* (quoting *United States v. Naftalin*, 441 U.S. 768, 778 (1979)). This Court held: "Since § 11 and § 10(b) address different types of wrongdoing, we see no reason to carve out an exception to § 10(b) for fraud occurring in a registration statement just because the same conduct may also be actionable under § 11." *Id.* at 382-83. Defendants' argument simply ignores this holding.

The opinion below neither changes the elements of liability under either § 11 or § 10(b), nor blurs the distinction between the separate requirements of §§ 11 and 10(b).

B. This Case Presents No Important Question Regarding When Companies Are Under A General Affirmative Duty To Disclose Data Concerning Clinical Trials

1. The Ninth Circuit Did Not Hold That In The Absence Of Affirmative Misrepresentations There Is A General Duty To Disclose Preliminary Clinical Testing Data

The Ninth Circuit did not hold that Medstone had a generalized duty to disclose preliminary test results. It held that defendants may have to reveal clinical testing data when they make representations *on the basis of clinical test results that actually contradict those representations*:

> Medstone argues that the study results were preliminary. But Medstone also bases its claim that Statements 1 and 2 were not misleading on the same study, characterizing the results as successful. *Having used the study results to justify its prospectus statements, Medstone may not simultaneously claim that the study was too preliminary to disclose.*

(A15-A16) (emphasis added). Acknowledging that the issue was a "close question," the court held only that failure to reveal the true study results could be deemed material in light of "Medstone's statement that the lithotripter was competitive and had been used successfully." (A16). This holding could not possibly be construed to create any broad new "duty" of disclosure such as that painted by defendants' petition for certiorari.

Section 11 imposes liability if a registration statement "contained an untrue statement of a material fact or omitted to state a material fact *required* to be stated

therein *or necessary to make the statements therein not misleading.*" 15 U.S.C. § 77k(a) (emphasis added). In *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 111 S. Ct. 2749, 2758 (1991), this Court held that by affirmatively stating its opinions on important corporate matters, management implicitly represents those opinions have a reasonable basis. Such statements "are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading." *Id.* at 2758. Under Ninth Circuit law, a statement may be actionable if it lacks a reasonable basis or is seriously undermined by material undisclosed information. (A17). In this case, the Ninth Circuit held that plaintiffs had presented evidence tending to show that defendants made material statements about the efficacy of a medical device when they lacked any reasonable basis for those statements. This evidence included clinical trial data available to defendants which showed the product did not work as claimed. (A10-A12).

Defendants' contention that the Ninth Circuit created a new "rule" requiring universal disclosure of all arguably material preliminary test results is nothing short of frivolous. This is a case where, irrespective of any preexisting obligation to disclose clinical data, defendants chose to make affirmative misrepresentations about that data. Thus this case, like *Basic Inc. v. Levinson*, 485 U.S. 224, 235 (1988), does not deal with a generalized affirmative duty of disclosure of preliminary data. It "does not concern the *timing* of a disclosure; it concerns only its accuracy and completeness." *Basic*, 485 U.S. at 235; *see Levinson v. Basic Inc.*, 871 F.2d 562, 563-65 (6th Cir. 1989).

2. Defendants' Contention That The Court Applied The Wrong Standard Of Materiality Is Frivolous

Defendants' contention that the Ninth Circuit applied the wrong materiality standard is frivolous.

Following this Court's precedents, the Ninth Circuit held that

> an omitted fact is material if a reasonable investor *would have been misled* about the nature of an investment in Medstone, *because there is " 'a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.' "*

(A28 (quoting *Basic*, 485 U.S. at 231-32) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976))). Dealing with test results that contradicted defendants' public statements in this case, the Ninth Circuit emphasized that

> [a]lthough a prospectus should not " 'bury the shareholders in an avalanche of trivial information,' " *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (*quoting TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49, 48 L. Ed. 2d 757, 96 S. Ct. 2126 (1976)), this information was not trivial, as the efficacy and competitiveness of Medstone's system was essential to the company's performance.

(A15).

Thus, in this case the Ninth Circuit simply restated and applied the materiality standard set forth in this Court's opinions in *TSC Industries* and *Basic*. (A14-A16,

A28). Defendants contend that although the Ninth Circuit stated the correct materiality standard, it actually applied a lesser standard because it observed that "a reasonable jury could find that the study results *might* have given a reasonable investor pause." (A16) (emphasis added). In fact the Ninth Circuit held defendants' statements and omissions met a *higher* standard of materiality than that demanded by this Court's precedents: "If the failure to disclose the clinical results *would have misled* the reasonable investor about the nature of an investment in Medstone stock, then the omission was material." (A15) (emphasis added). The Ninth Circuit's observation that "the study results might have given a reasonable investor pause" does not purport to state a new standard of materiality, and does not warrant review by this Court.

III. CONCLUSION

Defendants disagree with the decision below, but that is insufficient grounds for invoking this Court's jurisdiction with a writ of certiorari. The petition should be denied.

DATED: June 9, 1995

Respectfully submitted,

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